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# SERIE RESEARCH MEMORANDA

## Rethinking the Strategy of Amazon.com

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# **Rethinking the Strategy of Amazon.com\***

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**Abstract:** The strategic challenge facing Amazon.com is that it is not able to convince the investment community that it is able to generate profits in the long run. The doubt of investors is well grounded. This paper argues that Amazon should make a strategic shift to operate as a provider of technical services and business consulting in the area of business-to-consumer e-commerce. At the same time it should reduce the range of the items sold on-line to, say, books and CDs, and treat this part of its business as a kind of research and development activity. Its avant garde status as e-commerce innovator and its track record in customer satisfaction have tremendous market value and can serve as an “open sesame” to enter the huge market of e-commerce consulting. Its continuing survival and (hopefully) future profitability hold deeper implications for other dot.com companies and B2C e-commerce.

**Key words:** Amazon.com, financial market, B2C electronic commerce, strategy

## **1 INTRODUCTION**

The current strategy of Amazon.com is to develop and capture a substantial market of business-to-consumer electronic commerce. Once the milestone is reached, it can act as the de facto on-line retailers for all kinds of non-perishable consumer goods. A marginal percentage earned on the goods sold on-line would be sufficient to yield a handsome profit. Until that milestone is reached, it is part of the strategy of Amazon to spend money to develop the market and to be prepared to run up losses. The strategy makes sense when we are reminded by report (The Economist 23 November 2000) that e-commerce accounted for only 1 percent of total sales in America and it was growing rapidly. The strategy of making initial loss to establish a strong market position and to use the position to make money later is not new. It is a well tested approach used by newspapers and magazines and commercial TV stations which use

the entrenched market position to make money from selling advertisements. For dot.com companies, such business model is fine as long as the financial market shares their vision and confidence. The vision could have been wrong, but then this is the nature of business life, some may argue. Given the seductive gold mine if things go right, it is a risk worth taking. Such rationale explains well the willingness of investors to pour money to finance the innovative though very risky venture of these dot.com enterprises. It explains why some time back, the stock market capitalization of Amazon was higher than the entire traditional book retailing and publishing combined, even though Amazon had yet to yield profit (Evans and Wurster 1999).

The problem now is that the financial market has doubts about the value of dot.com companies as investments. Some stocks that cost \$100 last year have dived to cost \$1.50 at the point of writing (The Economist 6 January 2001). To the cool headed economists or financial market commentators, it represents a well-deserved lesson for speculators and an occasion to call upon those highly paid market analysts to account for their reckless recommendations. Though this may be an issue worth researching in itself, my concern here is the long-term viability of Amazon.com.<sup>1</sup>

The current model of many dot.com companies is unlikely to work. There are two main reasons in the case of Amazon. First, it is expensive to capture market from the old economy retailers and to develop new markets. And the marketing costs are not offset by the subsequent increased sales. This is most vividly reflected in the revenue figures. Increase in sales does not show any clear and permanent trend of returning net profits in the foreseeable future. More worrying is that losses tend to grow with increasing sales. Second, the technology and business practices behind the on-line retailing are not so unique and difficult as to constitute a huge entry barrier. They may be difficult to develop but the business practices and functional capabilities of the information systems are for all to see. The cost involved in starting eBay or Amazon may be high, but this is not a great deterrent to established old economy retailers who have mountains of cash to spend.

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<sup>1</sup> For the sake of transparency, I would like to state that I do not hold any share of Amazon.com. The position outlined in this paper has been ventilated to friends and colleagues long before the current malaise of Nasdaq.

Though investors and financial traders and analysts can argue about the value of Amazon.com, there is consensus in the appreciation of Amazon's business model as an organizational innovation (Heng and Xiao 2000). It would be a pity for innovative companies such as Amazon to go under.

The aim of this paper is to argue that Amazon.com should transform itself into a company selling its expertise in B2C electronic commerce to other B2C companies. To avoid conflict of interests, it should confine itself to selling books and CDs on-line, and should not sell its services to other on-line retailers of books and CDs. The **current** business is to be considered as a kind of research and development activity, to develop innovative technical applications and business practices. It is to the credit of Amazon.com that more than any other single company, it has developed many of the practices of on-line retailing, and it has become a household name and as an icon of B2C electronic commerce. This has tremendous market value if it decides to enter the electronic commerce as a provider of technical expertise and business consulting. It has a pool of top rate expertise, which can be used to generate incomes, which can boost the confidence of investors. This move is all the more urgent now that there is a surge of pessimism about the American economy and about high-tech companies.

The case of Amazon is of great concern to e-commerce and the Internet economy. By virtue of its high profile and its model status, its fortune affects public perception of other dot.com companies and Internet companies. Moreover its failures or successes hold valuable lessons for other B2C companies.

The rest of the paper is structured as follows. Section two sets out in more details the central position of this paper. Section three lists out some of the legitimate objections to my position, and provides point-by-point reply. Section four closes **the** paper with a discussion.

## **2 A NEW STRATEGY FOR AMAZON.COM**

Amazon Bookshop was set up in 1994 by Jeffery Bezos, who earlier on worked as a manager at Bankers Trust. It had a humble beginning with 7 persons in Seattle (Washington, USA) and has since evolved to become the standard bearer of B2C e-commerce. The company identifies "databases and shipping" as its core competencies and its operational heart consists of a battery of servers with databases (Creemers 2001). It is one of the firsts in e-commerce and has become an object of attention in business press, of study in textbooks and academic journals. Its high profile is well

deserved, for it has set the trend of e-commerce and introduced many innovative business practices in B2C e-commerce. “The site is designed to speed you through the process of browsing and ordering merchandise, while giving you reassuring, personal service at discount price. . . .The combination of efficiency, discount prices, and personal service is why Amazon is frequently mentioned as a model of customer service for businesses on the Web. (O’Brien 2000: 229). From the customers’ point of view, Amazon is certainly a great e-commerce company. Let us consider two key sets of strategic questions every enterprise has to ask (Drucker 1974). The first set deals with customers: who are our customers, and what are their needs and perception of value? The second set deals with the enterprise: what is its mission in trying to fulfil customers’ needs and what core competencies the enterprise must have to carry out its mission? Amazon has a good track record in handling these two sets of questions, and the number of its customers has grown explosively. The growth has been achieved by a strategy of customer acquisition and deep commitment of customer satisfaction, while treating returning profits as secondary (at least in the short term). The bankrolling of this strategy had been enabled by a favourable valuation of its stock by the capital market.

However, since the beginning of last year, its stock price has suffered a declining trend, which reflects the serious doubts of the financial market about its future as an investment. At one point, its stock price reached a 52-week low of \$13.563, less than one tenth of its peak of over \$150.<sup>2</sup> Below I would explain in sub-section 2.1 that the concern as to the continuing survival of Amazon is well founded. Then I would argue in sub-section 2.2 that the company has a bright future if it makes a strategic shift to transform itself into a vendor of technical services and business consulting in B2C e-commerce. The reasons for this proposal will be set out in sub-section 2.3.

## **2.1 A Serious Flaw in the Business Model**

A concept that can help us understand the business model of Amazon is *navigation*. The business of navigation means helping customers to search for the items they are looking for, and in the broader sense of the term, help them in the entire process of making a purchase. The expertise entails branding, cross-marketing,

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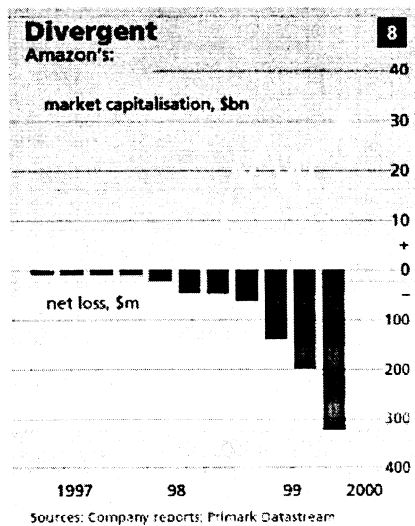
<sup>2</sup> Stock price data about Amazon.com are easily available at the website of Nasdaq.

advertising, relationship building and delivery. It is a business perceived to hold enormous potential. A well-known and trusted navigator can rapidly expand the range of items on offer • from books and CDs to wine, toys, greeting cards, auction services, and with a leap of imagination, even to cars (Creemers 2001). It was such the-sky-is-the-limit type of business prospects that excited the hearts of investors. The nature of the business is seen as a justification to focus on development of the market, first-move strategy, branding, expansion, expansion and expansion again. The first company to become the de facto giant on-retailer and to capture a growing share of the market will scoop the pool.

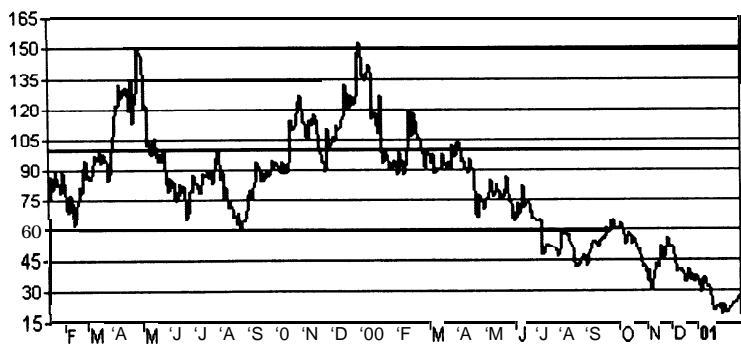
With the benefit of hindsight and experience, Amazon has under-rated the difficulty of implementing the model (if not the harsher issue of whether the model is too far fetched after all) and wrongly assessed the character of the consumer market. The brick-and-mortars retailers have also worked hard in striking back. And this point is crucial because these old economy players have been making money and therefore possess the financial ammunition. Let us also not forget the bandwagon effect of new dot.com companies imitating its *modus operandi*". "In the world of e-commerce, fast followers can replicate an innovative business model in [at] Internet speed (Fingar 2000: 66)." The use of Napster by music lovers to download their favourite pieces for free from the Internet threatens the on-line sale of music CDs. Moreover Internet privacy-protection software could undermine cross-marketing practice, a component of Amazon's business model (The Economist 28 Oct 2000).

These difficulties can be manifested in myriad forms, the most obvious of which is in the balance sheet. Here are some worrying financial figures (Creemers 2001). Sales in fourth quarter of 1999 amounted to \$676 million; the loss in the same period was \$323 million. The corresponding figures in the third quarter 1999 were \$356 million and \$200 million. With increased sales came increased losses, surely not an assuring trend. The figures for first quarter of 2000 were not too good: sales of \$574 million with loss of \$308 million. Even more disturbing is the fact that the company also finances its business activities with loans. Interests have to be paid and this can only exacerbate its cash flow problem. Pikelharing (2000) reports that "in the previous three years the company has borrowed to the tune of \$ 2,800 million while the turnover in the same period amounted to \$ 2,900 million (p.22)." In private

conversation, some e-commerce entrepreneurs confess perplexity as to how they ever will make a profit (Evans and Wurster 1999). One can only get more leery by observing such grim picture against a backdrop of a booming economy in last decade. Below is the chart taken from The Economist (Feb 2000), showing its losses.



The reaction of the capital market to the business performance of the on-line giant is translated into a downward movement of its share price. The decline in stock price may be interpreted to mean that our on-line star retailer has not been able to live up to expectation of the investors. From this perspective, the *raison d'être* of business enterprises is to yield a fair return from investment. It is a hard fact of economic life, in old economy, new economy, information economy, or Internet economy. Or as Shapiro and Varian remind (1999) their readers, the economic rules still hold.



<sup>3</sup> These newcomers are unlikely to challenge the dominant position of Amazon, but their business operations can hurt its revenue.



Movement of Amazon's stock price over the past 24 months  
(source: Nasdaq website)

## 2.2 Much Needed Strategic Shift

Companies are relying more and more on equity capital for funding (OECD 2000), or we may add, even for survival as independent businesses. This is illustrated by the behaviour of the capital market. In the last quarter of 1999 and the first quarter of 2000, the market showed an exuberant reception of Internet and dot.com stocks. Subramani and Waiden (1999) try to make sense of the phenomenon in terms of resource-based view of the firm (Peteraf 1993). According to such perspective, “the firm can be viewed as making investments in creating the resources to gear up for the large emerging e-commerce opportunity. These initiatives are advantages not only because they drive the firm up the learning curve in the activity but also because the path dependent resources created over time, organizational experience and understanding of e-commerce markets, are likely to provide the firm competitive advantage in future periods. (Subramani and Waiden 1999: 194)”

The atmosphere has led to the so-called dot.com effect, where the capital market rewarded e-commerce initiatives taken by companies by pushing up their stock prices. Sound and profitable firms associated with the old economy were dumped, forcing many of them to hurriedly to announce their own grand e-commerce strategies. Working within such reality, top managers have to be shrewd in formulating their strategy and presenting it in such a way as to boost investors' confidence or at least to retain it. This is not easy given the nature of capital market, with all its sentiments, unpredictability, irrationality and discipline (Kindleberger 1978 ).

The exuberant reception of dot.com companies turned out to exact an exorbitant price. The need for Amazon to chart a new strategic course was apparent since mid-2000, if not even earlier. It is becoming all the more urgent now that there is a surge of pessimism about the American economy and about high-tech companies.

The central issue is how to formulate a strategy to turn losses into profits, no matter how small. In terms of long term survival, the difference between -1 percent and +1 percent is greater than the difference between +5 percent and +10 percent. Here Amazon finds itself in a much better position than other dot.com enterprises. It has an intangible asset that is much in demand in the market. It has a pool of top rate expertise which can be used to generate incomes which can boost the confidence of

investors. To put it more concretely, **Amazon.com** should transform itself into a company selling its expertise in **B2C** electronic commerce to other e-business companies. The market is potentially very huge. As I stated in the Introduction, e-commerce accounted for only one percent of total sales in the USA and it was growing rapidly. Moreover, unlike other information technology related issues, e-commerce is an issue that has captured the attention and exercised the minds of corporate leaders.

To avoid conflict of interests, it should confine itself to selling a very narrow range of goods, say books and CDs. If it decides on selling books and CDs on-line, then it should not sell its expertise to other on-line retailers of books and CDs. This is to avoid conflict of interests. The current on-line retail business is to be treated as a research and development activity, whose main goal is to develop innovative technical applications and business practices. This is a normal and accepted business strategy to run its R & D as an internal investment, consuming resources in order to generate innovations. (The competitive advantages of Amazon in the proposed new strategy are discussed in the next sub-section.)

Possible services which can be offered by Amazon to other e-business are: building of B2C infrastructure, technical support services, business consulting, finance and accounting advice, recruitment and training. Besides offering such services to established companies keen on branching out to e-commerce, Amazon should also enter the market as incubator for e-business. Here it is to help a company in the start-up stage. Good incubators have a part to play in the Internet economy. This is especially true outside the Silicon Valley where appropriate support services for start-ups are lacking. "Too few aspirant incubators genuinely possess the skills they claim. Many have been started by smooth-talking consultants, eager to cash in on the Internet boom before it is too late, rather than by experienced entrepreneurs who have won their stripes in the trenches. (The Economist, 23 Dec 1999)."

One of the most important challenges facing organizations in the age of electronic commerce has become the development of new business strategies and models. New business models are challenging the logic and assumptions of traditional models. This is a manifestation of the fact that the new environment presents opportunities for some and threats for others. Bill Gates knows that competition today is not among products, but among business models; irrelevance is a bigger risk than inefficiency (Turban et al 2000, p.xxvii). Indeed, inability to outgrow the dominant, outdated business design and thinking is often what leads to business failure (Kalakota

and Robinson 1999). The pressure is now on companies to function in a state of more or less constant transformation. Senior management has to live with the challenges of earning revenues from well-tested practices while being prepared to experiment with new ideas which may undo these old practices. If fortune smiles on Amazon, it may well emerge from the current growing pains to become one of the loveliest darlings in Nasdaq.

### **2.3 The Competitive Advantages of Amazon.Com as a Vendor of e-Commerce Services**

Amazon enjoys two advantages, namely, its track record as the most innovative enterprise in B2C e-commerce, and the public recognition of this fact which carries with it immense market value in the form of brand name.

It is to the credit of Amazon.com that more than any other single company, it has developed many of the practices of on-line retailing. It has proved itself to be technically very innovative, and a report in *The Economist* (14 October 2000) bears the title *Amazon, the software company*. The same report informs us that “Whatever you think about Amazon’s long-term prospects, there is no doubting the online retailer’s ability to innovate. Every few weeks a new feature appears on its website . . . (p.92)” Its management team consists of persons who are well respected in the core competencies of Amazon (Creemers 2001. Earlier research has shown that its website is evaluated as the best well designed (Creemers 1999), a finding that has been confirmed time and again in the business press. It has an enviable reputation of customer satisfaction. This is no easy feat, given the bedeviling headaches encountered by other e-retailers in orders fulfillment. To quote the popular BBC program of Alistair Cooke (2001) 's *Letter from America*: For the home deliveries of books, chocolates and presents in general ordered over the Internet, one in four went to the wrong addresses or were not delivered.

Amazon’s technical and business innovations and its commitment to serve the consumers have earned it the reputation of being the market leader. “The name has become synonymous with e-commerce.. . . Today Amazon is one of the few Internet brands recognised the world over. It is the most visited e-commerce website in America, and one of the top two or three in Britain, France, Germany and Japan. (*The Economist* 26 Feb 2000).” And its role in the development of B2C e-commerce has also been publicly acknowledged. The *Time* magazine named Jeff Bezos as its person

of the year in 1999. Such honour, reserved for top newsmakers and world figures, has immense publicity value. It means a famous brand name, which remains critically important to Internet firms (Shapiro and Varian 1999; Gallagher 1999). In the current business of Amazon (to follow Gallagher) its well-known brand name supplies three important functions: (1) it lowers search costs, (2) it builds trust, and (3) it communicates quality (ibid). I have carried out some informal inquiries among the business practitioners as to whether they would choose Amazon as their vendor of e-commerce services. All of them replied with an unequivocal “yes”.

### 3 ADDRESSING SOME LEGITIMATE CONCERNS

There are three questions which arise from the position taken in the previous section, namely the question of cannibalizing one’s own business, the difficulty of learning a new business, and the challenge of competing with established vendors. I will deal with them briefly here, for reason of space limit of a conference paper.

One important misgiving about the proposed new strategy is the problem of Amazon cannibalizing the current business. It is a recurring dilemma confronting many brick-and-mortars retailers. In fact the answer is provided by the history of business and innovation. If the market trend is towards accepting a new innovation, be it automobile above horse carriage or personal computers above typewriters, there is little choice. During the transition period when we are not totally sure about the trend, it stands to reason to hedge the bet by investing in ventures that would battle among themselves. It is part of the game for one business to eat up another. We are here intellectually indebted to Joseph Schumpeter. Our good economic historian displays brilliance in his expositions of the nature and social dynamics of innovations (Schumpeter 1942; Frisch 1981). Until today we are still digesting his insights and are trying to work out ways to handle the opportunities and dilemma posed by innovations to business firms and the broader society. In the case of Amazon, the case is not even as serious as cannibalizing its own viable business. The choice is made easier in that the current on-line business has been burning money but it has provided the company with much coveted expertise and brand name.

The second question is related to the uncertainty, risk, difficulty in operating up a new business. The proposed new strategy would require it to learn the unique attributes or idiosyncrasies of each particular business, e.g. to know customer behaviours and to know where the inefficiencies are. Though there is no ironclad

guarantee of success, the track record of Amazon as an innovative enterprise augurs well. After all it has started from scratch, and has gone a long way in pioneering the e-retailing business.

The third question is related to the competition from established consultants and vendors of e-commerce. Given its brand name and know-how, Amazon is well positioned to tackle the problems encountered by other e-commerce companies and incubators. Competition is a blessing and should be welcome, for it can contribute to upgrading skills and improving innovations (Porter 1990).

#### 4 CONCLUDING DISCUSSIONS

While I first started drafting the paper, I wanted to use the title *An Open Letter to Amazon.Com*. In the course of writing, I dropped it in order to include this section in the paper. The fate of Amazon extends beyond the company and the concern of its stakeholders, and its fortune would be of great interests to the larger community. In other words, the continuing survival and its future brilliant prospects (hopefully) hold deeper implications for B2C electronic commerce and other dot.com companies. Amazon's woes are common to many other high-tech and dot.com firms. The central problem is that they have no net earnings. If Amazon is able to make a strategic shift in its focus successfully, it will provide interesting experiences for other similar companies, and given the current historical conditions of globalization (Micklethwait and Wooldridge 2000), the experiences and insights gained by Amazon can soon diffuse to many corners of the world.

Moreover, any success of Amazon can influence market perception of dot.com and other high-tech enterprises. While negative sentiment of the capital market is good in the sense of wiping out non viable ventures, it has also a few negative aspects. It makes it more difficult for promising newcomers to obtain funding. Even well established giants like Intel and Cisco may even have to assign to cold storage innovative projects. And most unnerving of all, some potential stars may not survive the current market malaise. Herein contains an important pointer for future research. The information system research community, perhaps working closely with accounting and finance research communities, owns the broader society in general and the investment community in particular a responsibility. Their aim is to devise a more robust and reliable way of assessing the long-term value of business ventures in the new economy, especially that of dot.com companies. Their findings will not frighten

away venture capital and thereby reduce its the potentially valuable contributions. The findings would tend to reduce the tendency of blind gamble. Put differently, they would help to reduce the disposition of reckless investment behaviour and help to transform high-tech investment into informed bet, by all means a healthy trait in an ambiguous and uncertain environment.

Just in case I could be perceived of being totally negative about any form of irrational behaviour of the capital market,<sup>4</sup> allow me to add the following remark. Innovation is a business that no one is known to have any special skill of making reliable prediction. Here a certain degree of risk taking and speculation is called for. Where public goods are involved, e.g. cure for a common disease, governments have the duty to allocate budget for them. Outside this domain, the investment community is undertaking a socially beneficial function by providing the finance in innovative and risky ventures. The investors do so in the hope of being bountifully rewarded if the investment turns out to be the proverbial goose that lays the golden egg. Here some element of irrationality is needed (Brunsson 1982); and given human greed and short sightedness, it is pretty unavoidable. Of course, some investors can end up losing their money. It is such investment climate that promotes the emergence of technical innovations, unconventional business practices, and novel business models. From a longer-term perspective, society would benefit even though individual investors may lose their shirts. I would like to paraphrase March (1994):

*Successful organisations build a 'can do' attitude that leads people to underestimate risk. Such attitude is likely to be prevalent in young, apparently successful high-growth firms where the environment conspires to induce investors to believe that they know the golden grail of investment. This risk under-estimation is a way of inducing investment that may prove to be very costly to the individuals concerned, but it may end up serving the larger society.*

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<sup>4</sup> A very readable account of some of these irrational and reckless behaviour ( more correctly termed speculative frenzies) can be found in MacKay (1841).

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